17.02 Accounting Changes: Entity & Error

3 - Change in Reporting Entity – (Retrospective Adjustment)

A **change in reporting entity** results in F/S that are essentially those of a different reporting entity, consisting primarily of:

- Presenting consolidated F/S in place of individual F/S for each entity.
- Changing the specific subsidiaries making up groups for which consolidated F/S are prepared.
- Changing the entities included in combined F/S.
- Changes between the use of the equity method of accounting and consolidation of a subsidiary without a change in the ownership percentage of stock.

A change due to a change in ownership, such as a business combination reported under the acquisition method, is not a change in reporting entity. It is a change in the actual entity and subject to different accounting and reporting guidelines.

A change in reporting entity is applied retrospectively and all prior periods' F/S that are presented are modified to reflect the new reporting entity as if that had been the reporting entity as of the beginning of the earliest period presented.

When making this change:

1. Prior periods presented are corrected.
2. Any remaining balance affects beginning Retained Earnings (net of tax), as a prior period adjustment.

The accounting for these changes requires the use of the **retrospective approach**, meaning that the presentation of all items in current and comparative previous years' F/S will be as if the combination of companies in the current F/S were always the same. Since these changes affect virtually every account on the balance sheet and income statement, computational problems on this type of change are generally beyond the scope of the exam.

Correction of an Error / Prior Period Adjustment – (Retroactive Adjustment)

Although a **correction of an error** is not considered an accounting change, it is accounted for in a manner similar to a change in accounting principle. When an error that had been made in a prior period's F/S is discovered, it is reported as an error correction and the prior F/S are restated. Although restatement is accomplished in the same manner as the recognition of a change in accounting principles, there is a distinction in the presentation and disclosure.

To report a correction of an error:

- The cumulative effect of the error on periods prior to the earliest period presented is reflected in the carrying values of assets and liabilities as of the beginning of the earliest period presented.

- An offsetting adjustment, if necessary, is generally made to the opening balance of retained earnings as a **prior period adjustment** but may be to another component of equity or net assets, as appropriate.
- F/S for each period presented will reflect the correction of the effects of the error on that period's F/S.

Examples include:

- Change from Non-GAAP to GAAP (cash to accrual, direct write-off method for credit losses to an allowance approach)
- A mathematical error
- Mistakes in applying GAAP (failure to record depreciation expense)
- Inventory Errors

Statement of Retained Earnings	
Beginning RE	$ xxx
+/– **Prior period adjustment** (net of tax)	**xx**
Adjusted beginning RE	xxx
+ Net income	xx
– Dividends	(xx)
Ending Retained earnings	$ xxx

If it is discovered in the current year that an error has been made in accounting in a prior one, the affected accounts are adjusted as of the beginning of the current year, and reported as a prior period adjustment to beginning retained earnings. It will be reported on the Statement of Retained Earnings of the current year, unless comparative F/S are being issued, in which case the accounting of the prior years will be corrected directly.

If only some of the prior years affected are being presented, the presented ones are corrected and the remaining effects are shown on the Statement of Retained Earnings of the earliest year being presented. The approach to correction of an error is an example of the retroactive approach. Retroactive application is the restatement of previously issued F/S to correct an error.

Inventory errors correct themselves after 2 years. If, however, an inventory error is found in the first and or second year, an adjustment may be required to both the balance sheet and the income statement. For example, if ending inventory of X1 is overstated, that means COGS for X1 is understated, so NI for X1 is overstated. In X2, the beginning inventory will now be overstated (since X1 ending inventory is now X2 beginning), so X2 COGS is overstated and NI for X2 is now Understated. Therefore, RE at the end of X2 is now correct (X1 income Over and X2 is Under, so it is a wash).

Required **Disclosures** for a Correction of an Error include:

- The effect of the correction on each financial statement line item and any per-share amounts for all prior periods presented.
- The cumulative effect of the restatement on retained earnings or other components of equity as of the beginning of the earliest period presented.
- A statement that previously issued F/S have been restated.